What seemed unthinkable 15 or 20 years ago is now a reality. In some respects, the world is becoming a single market with businesses from around the world competing for the same projects, no matter their geographic location. . . . It is within this context that transfer pricing is constantly evolving.¹

The lack of good information about intangibles leads to . . . opaqueness, volatility, and perceptions of unfairness in capital markets, and it makes designing a fair tax system more difficult.²


Transfer pricing’s increasing importance in international tax issues over the past two decades has coincided with an increase in the importance of intangibles in the global economy. The so-called new economy of the 21st century has seen business enterprises, particularly multinational businesses, divesting themselves of tangible assets while turning to intangible assets to enhance their standing in a world increasingly focused on technological innovation.

The spiraling cross-border trade in intangibles has compelled revenue authorities to scrutinize the tax treatment of those assets, even as they acknowledge that traditional tax practices may be difficult or even impossible to apply to such interaffiliate transactions, particularly when unique or high-value intangibles are involved. Therefore, there is a need to investigate creative and flexible solutions.

This article looks at the problems inherent in dealing with the transfer pricing of intangible assets from a tax standpoint. Some measures taken by revenue authorities in the United States and Australia — countries at the forefront of this rapidly evolving area of tax law — and views expressed in the OECD’s transfer pricing guidelines for multinational enterprises and tax administrations are comparatively examined.

**Tax Authorities’ Focus on Intangible Assets**

One of the factors linked to the effective operation of transnational businesses, and hence to the growth
of related-party trade, is the increasing role of valuable intangibles in the economy. The OECD guidelines cite technological progress as one of the reasons for the rise of the multinational enterprise in the global economy over the past 20 years. Studies show that international production is carried out by at least 61,000 MNEs with more than 900,000 foreign affiliates, representing foreign direct investment of about US $7 trillion.

Applying the arm’s-length standard is especially complex when the comparability of assets is reduced because of their unique nature, as with intangibles.

Transfer pricing in an international tax context in essence refers to the division of intragroup profits or losses when members of a multinational group are jointly responsible for those profits or losses. The potential for disagreement on that profit division is considerable, because taxpayers and tax authorities might have different perspectives on the appropriate amount of profit to be allocated to a particular member of the group in a specific country, and hence to the amount of tax payable there. That is a major problem for MNEs, because they are expected, “from the standpoint of the respective tax authorities, to warrant the highest tax base possible to each and every country where they operate.”

In those situations, the MNE often suffers double taxation (meaning that the same income is included in the tax base by more than one tax administration), as each country argues that it is entitled to the resulting tax revenue. The potential for controversy is heightened when intangible assets are involved because of their often unique nature, which necessitates negotiation and evaluation on a case-by-case basis. According to David Grecian, Australia’s assistant commissioner of taxation for international strategies and operations, one of the big growth areas for transfer pricing is in intellectual property. “Transfer pricing is easily the most complicated tax work. There is underpinning legislation, but you still have to make judgments on the commercial realities of what the taxpayers are actually doing,” Grecian said.

The arm’s-length standard is internationally recognized as the benchmark for determining the appropriate transfer price to be allocated to a transaction between two related parties. For example, in the United States, the regulations in Internal Revenue Code section 482, which establish the regulatory framework for dealing with transfer pricing, provide that:

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result). However, because identical transactions can rarely be located, whether a transaction produces an arm’s length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.

Although the arm’s-length standard seeks to ensure objectivity by treating affiliated enterprises as if they were independent enterprises dealing in the open market and, accordingly, by evaluating the intercompany prices charged, it is a fluid concept, as the interpretation of what constitutes an acceptable arm’s-length price may differ from country to country.

applying the arm’s-length standard is especially complex when the comparability of assets is reduced because of their unique nature, as with intangibles.

A recent global transfer pricing survey has drawn attention to a changing focus for tax authorities worldwide. Companies in 22 countries revealed

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4OECD guidelines preface, paragraph 1.
9U.S. Treas. reg. section 1.482-1(b)(1).
that although the most commonly audited transaction remains the sale of tangible goods, the percentage of those audits is decreasing,\textsuperscript{11} while the percentage of audits of intangible property is rising. Transfer pricing practitioners have said that "in future years, transfer pricing and the issues associated with intangible and intellectual property . . . will be higher on the radar screen of tax authorities than ever before."\textsuperscript{12}

In the United States, observers are predicting an increasing focus by the Internal Revenue Service on international intangible asset transactions, as evidenced by the publication in September 2003 of new draft U.S. regulations on the pricing of services and intangibles.\textsuperscript{13} One of the reasons the new regulations were proposed was to prevent taxpayers from slipping valuable intangibles out of the United States as part of an integrated services transaction, but practitioners have said that "although the benefit of hindsight may clarify what transactions involve a disguised intangible transfer, taxpayers, rather than the IRS, may be the ambushed party."\textsuperscript{14}

The current GlaxoSmithKline legal challenge to transfer pricing adjustments made by the IRS — including US $1.9 billion in adjusted royalty payments for licensed patents and other marketing intangibles — has further highlighted the significance of related-party intangible asset transactions. The main issue in the case is the IRS's contention that the company undervalued the importance of marketing intangibles played in the promotion of drugs in the United States, while overstating the importance of research and development and marketing performed in the United Kingdom. (For prior coverage, see Tax Notes Int'l, Oct. 24, 2005, p. 330.) The Australian Taxation Office (ATO) reportedly has also been experiencing a renewed interest in intellectual property transactions, specifically regarding marketing intangibles and the arm's-length nature of royalties paid and received.\textsuperscript{15}

The New Economy

Revenue authorities’ increased focus on intangible asset transactions is partly due to a change in the way developed economies operate. Companies that once invested primarily in tangible (physical) assets such as plant and machinery, farmland, and mineral resources now are investing in intangible assets such as brand names, human capital, intellectual capital, and research and development. Although intangibles are not a new phenomenon, economic forces have made them the major determinants of economic growth and business success:

The competitive atmosphere of the global marketplace has compelled MNEs to focus on continuous innovation, achieved by means of massive investment in intangible assets. A further contributing factor to this surge in the importance of intangibles in global trade is the rise of information technologies, especially the Internet.\textsuperscript{16}

\begin{quote}
Although intangibles are not a new phenomenon, economic forces have made them the major determinants of economic growth and business success.
\end{quote}

As a result, many successful MNEs, such as Coca-Cola and Ford, are divesting themselves of their physical assets to concentrate on intangible assets.\textsuperscript{17} Pharmaceutical giants such as Merck and Co. and Pfizer Inc. "have prospered not because they have built new factories for manufacturing and packaging pills, but because they have been technological leaders, spending substantial amounts on research and development to develop new pharmaceuticals."\textsuperscript{18} An extreme example of a successful new-economy corporation is Microsoft Corp., which at the end of September 2000 had only US $1.9 billion in property and equipment, while its market capitalization was around US $328 billion.\textsuperscript{19} Research has shown that "brand development, e-commerce and the sale and consumption of products embodying intellectual property are overtaking the sale of commodities as a proportion of world trade."\textsuperscript{20} Investment in intangibles has become a fundamental source of continuing profitability and increased market share for international corporations.

\begin{itemize}
\item \textsuperscript{11}Id., Figure 5 — Type of Transactions Audited (Parents).
\item \textsuperscript{12}Ernst and Young, International Tax Services, Transfer Pricing Brief, "Tax Authorities Closely Watching Intangibles in the Transfer Pricing Context," June 8, 2004, p. 1.
\item \textsuperscript{13}68 Federal Register 53448.
\item \textsuperscript{14}Thomas M. Zollo, Christopher P. Bowers, and Jeffrey P. Cowan Jr., “Transfer Pricing for Services: The New Wave Hits,” 82 Taxes, January 2004, p. 34.
\item \textsuperscript{15}Koenig, above note 7, p. 1.
\item \textsuperscript{16}Michelle Markham, “The Transfer Pricing of Intangibles” (Kluwer Law International, The Hague, 2005), chapter 1.
\item \textsuperscript{17}Id., chapter 3.3.1.
\item \textsuperscript{18}Blair and Wallman, above note 2, p. 1.
\item \textsuperscript{19}Id.
\end{itemize}
The ATO’s traditional approach of focusing on the use of intangible property by Australian subsidiaries of foreign MNEs — and thus on whether royalties paid were above what would be paid under an arm’s-length consideration — has changed with the realization that Australia is increasingly exporting intellectual property (IP). That change in direction has been confirmed by research performed by the Australian Trade Commission (Austrade) that showed strong growth in the number of Australian knowledge-based exporters, especially in businesses specializing in education, professional services, and medium- to high-technology-based manufacturing. It is expected that the ATO will begin requiring Australian taxpayers to demonstrate that they are being adequately compensated for the local development and ownership of valuable intangible property when access to that property is granted to related foreign associates.

Problems in Defining and Valuing Intangible Assets

There are inherent challenges for taxpayers and tax authorities alike in dealing with the transfer pricing of intangibles, in part because of the elusive qualities of those assets in an increasingly knowledge-based economy:

By their nature, intangibles are harder to measure, to quantify, to manage — harder even to define — than tangibles. . . there is no common language for talking about intangible sources of value, and what language there is tends to be ad hoc and descriptive rather than quantitative and concrete, making comparisons from one institutional situation to the next impossible.

The United States has attempted, in the final regulations of IRC section 482, to define as intangible any asset falling into one of six broad categories that has substantial value independent of the services of any individual. Although many types of intangibles are directly listed — patents, inventions, designs, copyrights, trademarks, brand names, franchises and methods, and a catch-all category of “any other similar item” that derives its value from its intellectual content rather than its physical attributes — the list is not exhaustive and falls short of including some of the less traditionally recognizable forms of intangibles, such as human capital intangibles.

In looking at what constitutes intangible property, the OECD guidelines concentrate on business rights (that is, on intangible property associated with commercial activities). The guidelines classify those commercial intangibles into two main categories: trade intangibles and marketing intangibles. Trade intangibles encompass patents, know-how, designs, and models, while marketing intangibles are defined as a special type of commercial intangible including trademarks, trade names, customer lists and distribution channels, and unique names, symbols, or pictures with important promotional values.

Unfortunately, problems arise even within those broad definitions, because the OECD guidelines acknowledge “know-how” to be an imprecise concept that may include secret processes or formulas or other secret information that is not covered by patent. A further complication is that know-how and trade secrets can be either trade intangibles or marketing intangibles, and it can also be difficult to distinguish income arising from trade intangibles from income arising from marketing intangibles.

There is no global definition of intangibles, so problems can arise when intangibles are defined differently in different jurisdictions.

In Australia, Division 13 of the Income Tax Assessment Act 1936 deals with transfer pricing in terms of international agreements and the determination of the source of specific income. Section 136AA(1), which concerns definitions pertaining to Division 13, does not contain a specific reference to intangibles. The closest definition refers to property, which includes a chose in action (an intangible right of ownership in a tangible thing that includes the right to take legal action on it), any estate, interest, right or power, whether at law or in equity, in or over property, and any right to receive income and services.

There is no global definition of intangibles, so problems can arise when intangibles are defined

22The Australian Trade Commission is the government agency that helps Australian companies get overseas business for their products and services by reducing the time, cost, and risk involved in selecting, entering, and developing international markets.


24Id., p. 2.

25U.S. Treas. reg. section 1.482-4(b).

26OECD guidelines, para. 6.2.

27Id., paragraph 6.3.

28Id., paragraph 6.5.

29Id., paragraph 6.12.
differently in different jurisdictions. The lack of clarity is exacerbated by a wider recognition of less traditional forms of intangibles, including human capital intangibles, advertising slogans, business models and strategies, and unique business cultures and philosophies. National definitions have failed to keep pace with the changes to what formerly were defined as intangibles.

A paper by the Australian Government Consultative Committee on Knowledge Capital (AGCCCK) on the management of intangibles says intangibles can best be defined by separating them into two categories: hard and soft. According to that theory, hard intangibles encompass information protected by law, such as trademarks and nonaccounting value evidenced by financial transactions such as goodwill. Soft intangibles include knowledge assets (what people know), relationship assets (who people know), emotional assets (motivation levels), and time assets (effectiveness levels). Although that categorization may be simple and useful, organizations have not necessarily kept up with the changing forms that intangibles may take. “Currently, people are aware of hard intangibles and often fail to understand [that] soft intangibles exist. That is even more problematic when 90 percent of intangibles are soft intangibles,” the paper said.

Measuring or valuing intangibles is an area fraught with difficulty.

Measuring or valuing intangibles is also an area fraught with difficulty. Accounting practice in relation to intangibles, especially in a new economy populated by intangible-rich companies, is acknowledged to need worldwide reform. Peter Fritz, chair of the AGCCCK, considers the central problem to be an outdated method of intangible valuation. He has dismissed the impending rollout of the International Financial Reporting Standards (IFRS) in Australia, saying, “Reporting intangible assets is an issue the accounting profession has walked away from.”

With the adoption of IFRS for Australia starting January 1, 2005, the new Standard 138 of the Australian Accounting Standards Board has changed the reporting and accounting for intangible assets in Australia, in that self-developed brands, mastheads, publishing titles, customer lists, and similar items no longer will be recognized as intangible assets. Some fear the change will:

- result in a derecognition of many existing intangible assets. It essentially ignores how self-generated or homegrown brands, as opposed to acquired brands, can create shareholder value and prohibits the recognition of other internally generated intangibles, such as human capital intangibles, as assets.

The disconcerting effect of the new standard is that, in an era in which investors are demanding more detailed information about intangible assets, the reporting of some internally generated intangibles will disappear from financial statements. Likewise, the U.S. Financial Accounting Standards Board does not require the valuation of internally generated intangibles. The problem is worldwide — while companies are investing heavily in intangible assets, there is a dearth of financial reporting of those assets.

Microsoft considers software development, its core competence, as an expense and writes it off in the year incurred. English football clubs do not include the value of their players in their accounts. Reuters, the leading electronic information provider, acknowledges that its balance sheet does not include the global databases of financial information or its software and other intellectual property.

One of the reasons that many accountants refuse to include some intangible assets in published financial statements is that they are inherently different than tangible assets. Intangible assets are often heterogeneous, defying comparability. One hour of software programming doesn’t necessarily equal another hour, while in the pharmaceutical industry, “only one in 4,000 synthesized compounds ever makes it to market and only 30% of those recover their development costs.” Human capital intangibles are especially difficult to measure. Although the potential output contribution of a new computer may be quantified, the contribution of a new computer programmer is less easily measured.

Further, intangibles don’t follow standard depreciation rules. Some depreciate rapidly, while others

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31Id.
32Id.
33The Australian equivalent of International Accounting Standards (IAS) 38.
34Markham, above note 16, chapter 3.3.3.
36Id.
37Id., p. 5.
appreciate with age (“like a good wine”), and still others experience ebbs and flows in their life cycle. Although accounting rules are designed to record discrete and sequential transactions, the value created by investments in intangibles is often contextual and dependent on complementary investments in other intangibles. For example, the value of a brand may depend on patent rights to some underlying technology, or on a creative advertising program. Moreover, a so-called failure in an R&D program might lead to insights that interact with the findings from another program and end up creating value in unexpected ways.

Another complication is that intangibles frequently are bundled with, or embedded in, tangible assets — for example, when a new technological process is incorporated into a machine. Those interactions also pose challenges to the valuation of intangibles, as revenue authorities may have to separate the tangible and intangible components of an item.

**There is a need for a broad, flexible, and globally harmonized definition of intangibles to promote the free flow of investment.**

In a world where transfers of technology across national boundaries are increasing, there is a need for a broad, flexible, and globally harmonized definition of intangibles to promote the free flow of investment. In the United States, Baruch Lev, professor of accounting and finance at New York University, Stern School of Business, has called for the standardization of intangibles-related information by an appropriate policymaking body such as the Financial Accounting Standards Board. He also has proposed an information system known as the Value Chain Blueprint, which evaluates the fundamental economic processes of innovation from the discovery of new intangibles through their development and implementation and, ultimately, their commercialization.

In Australia, the AGCCKC has said that a set of comprehensive, tested, globally accepted standards for financially valuing, reporting, and strategically managing all forms of intangibles is needed to deal with the widespread move toward investment in intangibles in the new economy. It also has highlighted the need for international awareness and cooperation regarding knowledge capital and for an ultimate goal of worldwide agreement on the measurement of knowledge capital.

### Other Problems

#### Ownership Issues

In addition to the problems of defining and valuing intangible assets for transfer pricing purposes, numerous other problems have arisen regarding those assets. There are different concepts of ownership of intangibles, ranging from bare legal ownership to economic ownership. Determining the ownership of intangible assets is important in relation to their international tax treatment, because the owner of those assets in a group situation generally is entitled to the income from them.

This area lacks clarity across the U.S. transfer pricing regulations, the OECD guidelines, and Division 13 of the Income Tax Assessment Act 1936 in Australia. Legal ownership is largely a matter of form, predicated on the legal registration of patents, trademarks, copyright, and designs. Economic ownership relates more to the substance of interaffiliate relationships, in that the party bearing the greatest share of the costs of developing or enhancing the intangible (and likewise bearing the greatest risk should the item fail to deliver value) is deemed to be the owner. Although economic ownership relates to economic realities, applying legal ownership may lead to a haphazard treatment of intangibles, because proprietary-rights strategies vary not only among countries, but also among MNEs.

When the U.S. transfer pricing regulations were issued in 1994, a radical change in the treatment of intangibles was introduced in that legal ownership was given precedence as far as legally protected intangibles, such as patents, were concerned. (Economic ownership is still applied in the case of intangibles that are not legally protected, such as know-how.) Although that move has been criticized by practitioners, the proposed IRC section 482 regulations issued in September 2003 not only endorse the application of the legal ownership test, but also allow the IRS to impute legal ownership based on the perceived control of an intangible asset.

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38Id., p. 4.
39Blair and Wallman, above note 2, p. 20.
40Id.
43Plakalo, above note 30, p. 3.
44Markham, above note 16, chapter 3.2.1.
Unfortunately, according to some observers, “the language of the proposed regulations in this case gives the IRS broad discretion to recharacterize related party transactions based on subjective judgements.”46 Further, the proposed changes to the determination of income attributable to an intangible have produced further uncertainty, because “the control standard indicated may not necessarily point to a single owner in all cases.”47

The OECD guidelines do not specify whether a legal ownership or economic ownership test should be applied to intangible assets for transfer pricing purposes, which has led to conflicting interpretations. The Australian legislation is likewise silent on that point. Although “the economic ownership test appears to be the yardstick most closely aligned with economic realities,”48 it now seems unlikely that that test will be globally applied.

Transfer Pricing Method Issues

Revenue authorities in the United States and Australia favor so-called traditional transaction methods for determining whether the transfer prices charged between related entities in a group situation comply with the arm’s-length standard. Those methods, which have also been endorsed in the OECD guidelines, focus on the comparability of the intangible transaction under review with intangible transactions conducted by independent, or unrelated enterprises. However, given the unique nature of intangible property, problems arise when attempting to conduct a comparative analysis.

The OECD guidelines acknowledge that intangible property may have a “special character”49 that complicates the search for comparables and that even when business activities are deemed to be sufficiently similar to generate the same profit margin, a minor difference in the property transferred could materially affect the price, necessitating adjustments.50 In the United States, the use of transaction-based methods in relation to intangible asset transactions is restricted to the comparable uncontrolled transaction method. That method involves an evaluation of whether the amount charged for a controlled (or independent) transfer of intangible property was at arm’s length by examining the amount charged in a comparable uncontrolled trans-

51U.S. Treas. reg. section 1.482-4(a).
52Id., section 1.482-4(c)(2)(ii).
53See, for example, TR 97/20, “Income tax: arm’s-length transfer pricing methodologies for international dealings.”
54TR 94/14, “Income tax: application of Division 13 of Part III (international profit shifting) — some basic concepts underlying the operation of Division 13 and some circumstances in which section 136 AD will be applied,” paragraph 353.
55Id., paragraph 355.
56Markham, above note 16, chapter 4.6.1.
the residual profit-split method has been viewed as a last resort, there now seems to be some acceptance of the fact that when there are no comparable transactions, it may be more practical to focus on the profits actually earned, rather than on the hypothetical profits that ought to have been earned at arm’s length in the situation. The ATO has conceded that although profit-split methods are a less direct way of applying the arm’s-length principle, they may be “most appropriate for cases where a more direct comparability on price or profit margin is not possible or practicable.”\textsuperscript{56} Other OECD countries, such as Canada, also seem to have become more open to the idea that profit-split methods can provide the best means of achieving a result in keeping with the arm’s-length principle when nonroutine intangibles are involved and good-quality comparable transactions are not available.\textsuperscript{58}

### Transfer Pricing Penalties and Audits

Bearing in mind the problems with the definition, valuation, ownership, and transfer pricing methods applied to interaffiliate intangible asset transactions, difficulties could arise when MNEs seek to provide revenue authorities with the required documentation regarding those transactions. That is especially the case as the trend among taxing authorities worldwide in recent years has been to introduce more onerous documentation requirements and increasing penalties for any inadequacies in the information provided. Australia and the United States were the first two countries to introduce transfer pricing documentation rules in the mid-1990s,\textsuperscript{59} and since then, many more countries have followed suit, seeking to ensure that they secure or increase what they regard as their fair share of an MNE’s taxable income.

One observer says that when MNEs engage in cross-border transactions involving intangibles, this problem often arises: “Tax compliance practices are developed according to each country’s own domestic legislation and administrative procedures, therefore each country enforces its own specific documentation rules and regulations, as well as its own particular penalties for non-compliance.”\textsuperscript{60} The OECD guidelines provide no guidance about specific transfer pricing documentation requirements, and administrative procedures may differ substantially from country to country.

In Australia, for example, transfer pricing penalties range from 50 percent of the tax avoided (if the arrangement is deemed to have been entered into for the sole or dominant purpose of reducing or eliminating tax) to 25 percent of the tax (if the taxpayer has a reasonably arguable position). In other cases, 25 percent of the tax avoided must be paid as a penalty (or 10 percent if the taxpayer has a reasonably arguable position). Unfortunately, no definition of what may be “reasonably arguable” is provided, nor does the ATO specify the extent of the documentation it requires, or even provide a checklist of documentation that is desirable. Instead it states that it “does not expect taxpayers to prepare or obtain documents beyond the minimum needed to make a reasonable assessment of whether they have complied with the arm’s length principle in setting prices or consideration.”\textsuperscript{61} That minimum will of course vary from taxpayer to taxpayer, because each business will have to be evaluated according to its own circumstances, including whether it participates in intercompany transfers of intangible property. The ATO recommends that taxpayers use their commercial judgment according to what a prudent businessperson would do.\textsuperscript{62} The onus is on the taxpayer to supply all the necessary documentation on intrafirm transactions and to ensure compliance with the arm’s-length principle. If the documentation supplied by the MNE is incomplete, it will be difficult to avoid penalties.

In the absence of any real guidelines on the extent and depth of documentation required, it is no surprise to discover that most companies do not meet the documentation requirements. A clarification of the ATO’s documentation requirements would greatly assist taxpayers in avoiding penalties imposed for deficient documentation.\textsuperscript{63}

In the United States, transfer pricing penalties range from 20 percent to 40 percent of the amount of tax that has been underpaid.\textsuperscript{64} The transactional penalty applies to valuation misstatements falling outside a safe harbor range that result in an underpayment of tax. However, penalties may be avoided even if a transaction falls outside the safe harbor range, if the taxpayer can show reasonable cause.

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\textsuperscript{57}TR 94/14, above note 54, paragraph 349.
\textsuperscript{58}See Canada Revenue Agency’s APA Program Report 2003-2004, Table 5, which demonstrates the profit-split method, the predominant transfer pricing method used in Canadian APAs.
\textsuperscript{59}Ernst and Young, Transfer Pricing 2003 Global Survey, above note 10, p. 8.
\textsuperscript{60}Markham, above note 16, chapter 6.1.
\textsuperscript{62}Id.
\textsuperscript{63}Markham, above note 16, chapter 6.3.
\textsuperscript{64}See U.S. IRC section 6662.
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and good faith. Once again, what may constitute reasonable cause and good faith is not defined and requires a case-by-case determination.

The net adjustment penalty applies if the net section 482 transfer price adjustments for the year exceed thresholds. Having reasonable cause for the transfer price is not enough, and there is no good-faith exception to the imposition of the net adjustment penalty, increasing the likelihood of its imposition.

In addition to the increasing compliance burden, the risk of a transfer pricing audit is high in both Australia and the United States. The ATO will, as a matter of principle, review transfer pricing as part of a taxpayer's tax audit or risk review. Intangibles (both Australian and foreign-owned) reportedly have been receiving attention recently. Each year, transfer pricing audits result in the assessment of hundreds of millions of dollars' worth of tax and penalties. Likewise, the IRS is known for extensively regulating transfer pricing and, as mentioned above, increasingly focusing on intangible asset transactions.

With transfer pricing remaining the "most significant international tax issue facing international business today, and in the foreseeable future," and with intangible assets becoming vitally important to a multitude of businesses in the global marketplace, controversy management is emerging as a high priority for MNEs.

Controversy Management: The Mutual Agreement Procedure

The mutual agreement procedure (MAP), as enshrined in article 25, has been a part of the OECD model income tax treaty since it was first issued in 1963. The MAP provides a way for the revenue authorities of countries that are parties to a double tax treaty and that disagree on the amount of tax to be levied on an MNE in a jurisdiction to resolve their dispute.

The rationale for the MAP is the avoidance of double taxation (when the same income is taxed by revenue authorities in two different countries). The corresponding adjustment mechanism seeks to even out any increases in the amount of tax levied by one jurisdiction according to the arm's-length principle (the primary adjustment) through a corresponding downward adjustment to the tax liability of the MNE in another jurisdiction. Obviously, tax administrations may be reluctant to forfeit what they regard as their fair share of taxation so that another tax administration may obtain a larger portion of that tax.

Although the avoidance of double taxation is a worthwhile goal, the procedure is notoriously lengthy. According to one transfer pricing expert:

The company that has operations in Australia and the US just wants to get on with business. But if, say, the Australian Taxation Office (ATO) says it wants more of the profits booked in Australia, a company can get caught between two governments and that's not a good place to be. These disputes can drag on for 10 years.

Tax administrations are under no compulsion to resolve disputes by way of a MAP. That is because article 25 of the OECD model tax treaty simply instructs competent authorities (the treaty country


71Ernst and Young, “Transfer Pricing 2003 Global Survey,” p. 4.

72Stephen Breckenridge, Baker and McKenzie, quoted in Abernethy, above note 8, p. 98.
related to "endeavour to resolve" those disputes. Taxpayers also have criticized the lack of transparency and lack of taxpayer involvement in the procedure.

Related-party intangible asset transactions are particularly susceptible to disputes between the taxing jurisdictions involved. The agreement establishes principles and guidelines to improve the performance and efficiency of the MAP under the Canada-United States double tax treaty. It lists seven examples of transfer pricing issues that those two competent authorities have failed to resolve, including the determination of an arm's-length value for nonroutine intangible assets and the characterization of a transaction as a service agreement or a licensing of intangible assets.

David Grecian of the ATO summed up the situation as follows: "There are no vanilla cases; you're dealing with intangibles and you're dealing with other taxation authorities. We meet with the competent authorities on a set program called a mutual agreement procedure, but this is still a fine science. Everything is always changing."73

The OECD on July 27, 2004, released a draft progress report, "Improving the Process for Resolving International Tax Disputes," which offers useful suggestions for reducing the number of cross-border tax disputes. One major recommendation is the introduction of supplementary dispute resolution techniques such as mediation and arbitration, on either an optional or a mandatory basis. Greater transparency and more efficient time frames have also been advocated. Although that is a step in the right direction, no final decision about the implementation of those proposed reforms has yet been made.

The need to reform the MAP process also has been highlighted by the Pacific Association of Tax Administrators (PATA), which on June 25, 2004, issued guidance to support the resolution of MAP cases among PATA members (Australia, Japan, Canada, and the United States).74 Although that guidance seeks to ensure the consistent and timely treatment of the cases75 and sets a two-year target for the completion of MAP cases, it doesn't modify the MAP rules and procedures established under the domestic law, policies, or procedures of the PATA members. Also, it creates no legal rights or obligations between the members. Whether the guidance will have a beneficial effect on MAP proceedings between PATA members remains to be seen, but the effect of the lack of compulsion to reach a mandatory resolution has already been noted.

Controversy Management: Advance Pricing Agreements

An advance pricing agreement is a formal agreement between the taxpayer and one or more revenue authorities on three basic issues:

1. the factual nature of the intercompany transactions to which the APA applies;
2. an appropriate transfer pricing method (TPM) to apply to those transactions; and
3. the expected arm's-length range of results from the application of the TPM to the transactions.76

The main advantage of an APA is that potential transfer pricing problems, such as the imposition of double taxation, can be addressed prospectively. Australia signed the world's first APA with the United States in 1991, and both the IRS and the ATO have promoted APAs as a cooperative venture77 that provides taxpayers with certainty about the tax treatment of their international transfer pricing transactions, including interaffiliate transfers of technology. (The effective period of an APA is usually three to five years in Australia, while the United States favors five-year agreements.) Australian companies lead the global market in the use of APAs, and 83 percent of those companies that have used an APA would consider doing so again.78

David Grecian, quoted in Abernethy, above note 8, p. 38.

73MAP Operational Guidance for Member Countries of the Pacific Association of Tax Administrators.
74Id. Section 1, Purpose of Guidance.
75Ernst and Young "Transfer Pricing 2003 Global Survey," p. 22.
Young 2003 global transfer pricing survey revealed that although only 21 percent of U.S. parent companies reported the use of an APA as a controversy management tool in 2003, 80 percent of U.S. subsidiary companies that had used APAs intended to renew those APAs.79

Practitioners have expressed different views about the use of an APA for intangible asset transactions. Some believe APAs may be too rigid for any industry undergoing constant change. The market for intangibles is necessarily dynamic, and it may be difficult to predict an arm’s-length range of results over a three- to five-year period.

What may have appeared to be an appropriate APA to use at the beginning of this period may change at some later point. There may be a need to update comparables, particularly in a field of enterprise (such as computer technology) where advances are constantly being made.80

According to one U.S. practitioner, although the APA process may be useful when straightforward issues such as routine intangibles are involved, there may be problems when controversial issues, such as the allocation of income regarding high-value intangibles, must be resolved.81

However, another U.S. transfer pricing analyst has said APAs may be especially beneficial when transactions involve unique or technologically sophisticated products or transfers of difficult-to-value intellectual property.82 The ATO likewise adopts the view that transactions involving transfers of intangible property are particularly suited to the APA process.83

That view is borne out by the fact that APAs have addressed situations involving high-value intangibles.84 In the United States, 10 APAs dealing with the use of intangible property by a non-U.S. entity were executed in 2004, along with 6 APAs dealing with the use of intangible property by a U.S. entity. In Australia, 4 out of a total of 23 APAs completed during the 2003-2004 tax year involved intangibles.85 Like the IRS, the ATO encounters a range of APAs involving the inbound or outbound licensing of intangibles every year.86

Perhaps one of the main advantages of using an APA when intangibles are transferred in cross-border interaffiliate transactions, and thereby risk scrutiny by revenue officials, is that a resolution can be reached relatively swiftly.

A taxpayer can avoid a time-consuming and expensive tax controversy with the IRS by entering into an APA. Because tax controversies have several phases (audit, appeals office consideration, litigation, and, sometimes, competent authority consideration), many of the litigated transfer pricing cases have lasted 10 to 15 years from the audit phase through completion. Competent authority consideration alone may take five to seven years.87

**Conclusion**

The transfer pricing of intangibles is inherently complex, regardless of the type of controversy management used in seeking a satisfactory outcome, both for taxpayers and tax administrations. Dealing with intercompany transactions involving intangibles is difficult for all parties to an APA—especially because there is no global definition of intangibles, and even national definitions have failed to keep pace with the changes and extensions to what were formerly defined as intangibles.

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80Markham, above note 16, chapter 8.6.8.


83TR 95/23, “Income tax: transfer pricing — procedures for bilateral and unilateral advance pricing arrangements,” paragraph 52.


86Id., p. 7.

elements require disaggregation for tax purposes. The ATO has acknowledged those problems, stating:

We try to spend time ensuring that the intangibles are clearly identified before they are rewarded. We have found it necessary to clearly establish the existence and nature of the intangibles before attempting to attribute to them any value or take them into account in applying an arm's length methodology.  

Ownership issues also must be resolved, especially the tension between legal and economic ownership. In light of the changing stance toward ownership, especially in the United States, MNEs should carefully document and structure their related-party transactions to prevent a group member from being imputed with ownership when that does not reflect the reality of the situation.

Applying a traditional transactional method to determine the arm's-length nature of an intangible asset transaction presents challenges because of comparability issues in relation to intangibles' specialized nature. A solution may be not only for revenue authorities to adapt to the proliferation of intragroup intangibles in the global economy by adopting a more flexible stance toward the choice of transfer pricing methods, but also to be innovative in devising new ways of dealing with dynamic enterprises that are subject to continual change. APAs may be an ideal vehicle for that innovation, because they can be made to suit individual fact scenarios. For example, the flexible profit-split matrix developed in Australia a few years ago for an APA in the electronics industry was a first.  

It is still necessary for taxpayers and tax authorities to realize that significant changes are taking place in the global economic landscape, and that relevant, creative, and flexible solutions are required to deal with the fact that "the present and the future is no longer shaped by physical flows of material goods and products but by ethereal streams of data, images and symbols."  

If important players involved in the international tax treatment of intangibles in the transfer pricing context can agree that a new, cooperative, and coherent approach is necessary to meet the demands of a worldwide shift toward investment in technology, it would have "the potential to release more of the natural dynamism in the business sector to stimulate innovation and encourage global trade in intangible assets. This in turn can only benefit national governments. It is a path worth pursuing."  

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91Markham, above note 16, chapter 9.8.